The Money and Bond Markets in July

Uneasiness over the persistence of inflationary pressures in the economy and the further rapid growth of the money supply pervaded the financial markets during July. Short-term interest rates rose over the month, as the Treasury embarked on heavy seasonal borrowing and the Federal Reserve reduced the provision of nonborrowed reserves. Long-term corporate interest rates edged higher, too, despite a tapering-off in sales of new issues. Municipal bond yields, however, receded until late in the month, when they worked higher.

On July 15 the Board of Governors of the Federal Reserve System approved a ¼ percentage point increase to 5 percent in the discount rate at four Federal Reserve Banks, and the remainder followed shortly thereafter. The increase in the discount rate was intended to bring it into better alignment with short-term interest rates—commercial banks had raised their prime lending rate by ½ percentage point about two weeks earlier—and also to signal the Board's continuing concern over substantial cost-push inflation. The widely anticipated changes in the discount and prime rates had only a minor impact on the financial markets in July, given the sharp climb in market rates during the preceding months. Despite the restraint imposed by the System on nonborrowed reserves, the narrow money supply, M_1, continued to expand very rapidly in July. The broad money supply, M_2—which includes the public's holdings of commercial bank time and savings deposits other than large certificates of deposit (CDs)—posted only a moderate gain, and growth of the adjusted bank credit proxy was also moderate.

In the Government securities market, much of the attention during the month centered on the Treasury's refunding of $5.06 billion in notes and bonds maturing in August. On July 21, the Treasury announced that it would offer a four-year three-month note priced to yield 7.06 percent and a ten-year bond priced to yield 7.11 percent in exchange for the maturing issues. The Treasury also indicated that it would accept cash subscriptions up to a maximum of $10,000 from private individuals for the ten-year bond. Preliminary results of the refunding, announced on July 30, indicated an attrition of $1.4 billion or 33.6 percent. At the conclusion of the financing, the Treasury disclosed that it would cover the attrition and raise additional cash by auctioning $2.5 billion of a new eighteen-month 6½ percent note.

THE MONEY MARKET

The money market firmed significantly in July, as the System provided reserves more reluctantly. Nonborrowed reserves rose by only $102 million (not seasonally adjusted)—which is but a small fraction of the normal seasonal rise in July—following the $553 million decline in June. On a seasonally adjusted basis, nonborrowed reserves dropped by $325 million in July, after a $160 million decline in June. At the same time, member banks relied more heavily on the discount window to obtain reserves. Indeed, during the second and third statement weeks in July, when reserve city banks were heavy borrowers over each weekend, borrowings approached or exceeded $1 billion. For the month as a whole, borrowings averaged $830 million (see Table I), up sharply from the June level of $514 million. Reflecting this rise, net borrowed reserves rose by $354 million to $658 million, the largest reserve deficit in about a year.

As bank reserve positions tightened during the month, banks continued to bid more aggressively for Federal funds, putting upward pressure on the rate in this market. Thus, the average effective rate on Federal funds during July rose by 40 basis points to 5.31 percent. Among other market rate changes, major commercial banks lifted their prime lending rates to 6 percent, up from the 5½ percent level that had prevailed since late April. This action, which followed the Independence Day holiday, had been widely anticipated in the markets and was the culmination of the broadly based uptrend in money market rates that had occurred during June. Also in July, dealers increased their offering rates on prime four- to six-month commercial paper by 13 basis points, while dealers' secondary market offering rates on three-month CDs rose by about 20 basis points. No net changes occurred in the rates on bankers' acceptances or on ninety-day sales finance company paper (see Chart I). Three-month Euro-dollar rates rose by about 19 basis points from June 30 to July 30.

Table I

FACTORS TENDING TO INCREASE OR DECREASE MEMBER BANK RESERVES, JULY 1971

In millions of dollars; (+) denotes increase (−) decrease in excess reserves

Factors	Changes in daily averages—week ended July 7	July 14	July 21	July 28	Net changes
"Market" factors					
Member bank required reserves	+ 24	− 213	− 391	+ 114	− 466
Operating transactions (subtotal)	− 386	− 476	− 40	+ 562	− 340
Federal Reserve float	+ 378	+ 213	+ 24	− 427	+ 188
Treasury operations*	− 54	− 244	+ 176	+ 204	+ 82
Gold and foreign account	− 4	+ 8	− 4	+ 29	+ 29
Currency outside banks	− 616	− 483	− 336	+ 811	− 624
Other Federal Reserve liabilities and capital	− 90	+ 30	+ 100	− 56	− 16
Total "market" factors	− 362	− 689	− 431	+ 676	− 806
Direct Federal Reserve credit transactions					
Open market operations (subtotal)	+ 451	+ 34	+ 613	− 381	+ 717
Outright holdings:					
Treasury securities	+ 166	+ 208	+ 25	+ 27	+ 426
Bankers' acceptances	+ 1	− 3	− 4	+ 1	− 5
Repurchase agreements:					
Treasury securities	+ 207	− 134	+ 537	− 386	+ 224
Bankers' acceptances	+ 30	− 17	+ 47	− 2	+ 58
Federal agency obligations	+ 47	− 20	+ 8	− 21	+ 14
Member bank borrowings	− 89	+ 330	+ 131	− 577	− 205
Other Federal Reserve assets†	+ 45	+ 53	+ 11	+ 31	+ 140
Total	+ 407	+ 417	+ 755	− 929	+ 650
Excess reserves	+ 45	− 272	+ 324	− 253	− 156

	Daily average levels				Monthly averages
Member bank:					
Total reserves, including vault cash	30,313	30,254	30,969	30,602	30,535‡
Required reserves	30,036	30,249	30,640	30,526	30,363‡
Excess reserves	277	5	329	76	172‡
Borrowings	661	991	1,122	545	830‡
Free, or net borrowed (−), reserves	− 384	− 986	− 793	− 469	− 658‡
Nonborrowed reserves	29,652	29,263	29,847	30,057	29,705‡
Net carry-over, excess or deficit (−)§	160	165	3	116	111‡

Note: Because of rounding, figures do not necessarily add to totals.

* Includes changes in Treasury currency and cash.

† Includes assets denominated in foreign currencies.

‡ Average for four weeks ended July 28.

§ Not reflected in data above.

Market observers continued to scrutinize the published statistics on the monetary aggregates during July, although weekly and even monthly movements of these series are often erratic and are generally known to be very difficult to interpret. On July 16, published statistics indicated an unusually large $3.2 billion rise in the money supply for the statement week ended July 7. Although the money supply dropped by $1.3 billion in the subsequent week, growth for the month was nonetheless strong. The daily average money supply (M_1) rose in July at an 11.2 percent seasonally adjusted annual rate, following the 11.3 percent rise in the money supply over the second quarter. Commenting on these developments in his July 23 testimony before the Joint Economic Committee, Chairman Arthur Burns indicated that these rates of growth are higher than is necessary or desirable over any length of time to sustain healthy economic expansion. He also noted that the Federal Reserve has already taken some steps to promote a more moderate rate of monetary expansion.

Following the pattern that emerged in the second quarter, most of the other monetary aggregates grew at markedly more moderate rates in July than did M_1. The broader measure of the money supply, M_2—defined to include M_1 plus commercial bank savings and time deposits other than large CDs—continued to slacken, with July growth estimated at an 8.5 percent seasonally adjusted rate as compared with the 11.0 percent rise in June. The slower expansion of M_2 in July resulted largely from the weaker inflows of savings and time deposits other than large CDs. Time deposit growth in July was roughly half that occurring in the second quarter of 1971. The adjusted bank credit proxy—member bank deposits subject to reserve requirements plus certain nondeposit sources of funds—rose at a 7.6 percent seasonally adjusted annual rate in July, slightly above the expansion rate that occurred in the second quarter. One factor tending to retard the growth of the proxy relative to M_1 and M_2 has been a steep rundown in Government deposits, which are not included in M_1 or M_2. Large CDs, which are included in the adjusted proxy but not in M_2, rose by about $737 million at the twelve weekly reporting banks in New York City, as some banks continued to bid aggressively for funds from this source.

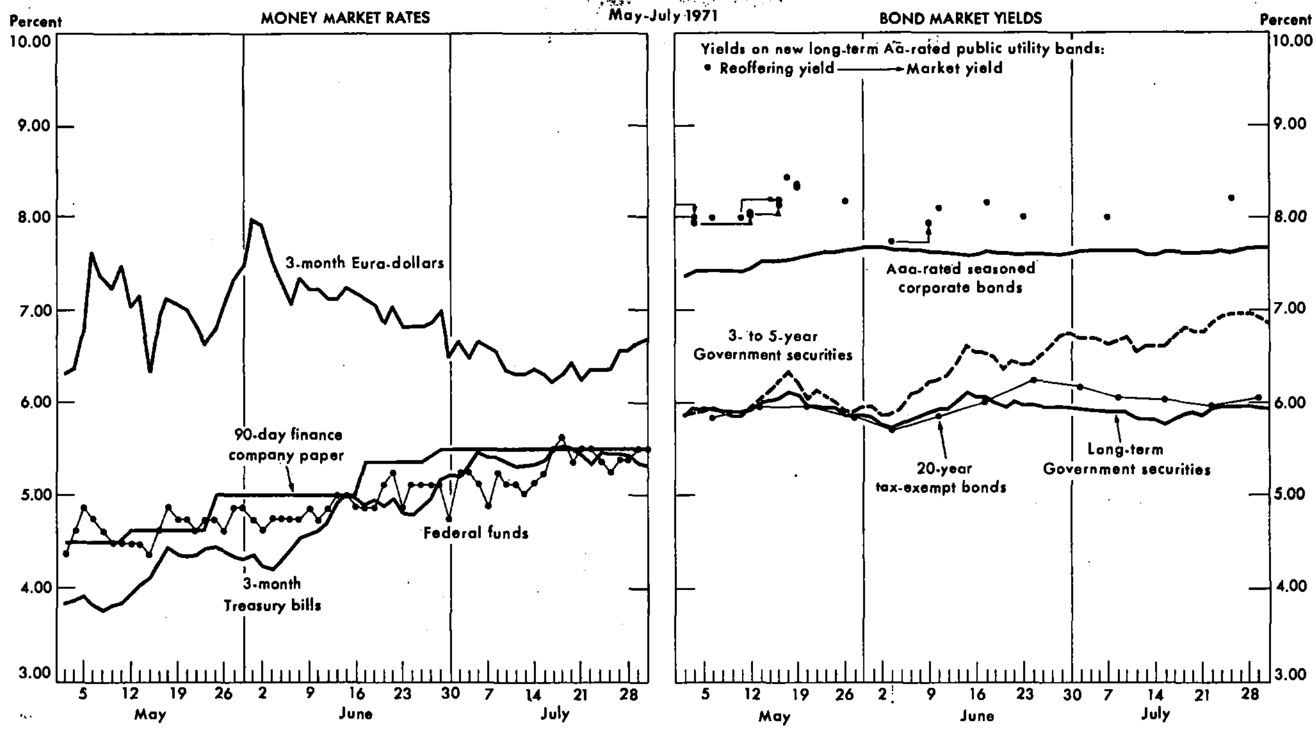
THE GOVERNMENT SECURITIES MARKET

The rapid growth of the money supply, the rise in the discount rate, and firming money market conditions at midmonth all contributed to a generally cautious atmosphere in the market for United States Government securi-

Chart I

SELECTED INTEREST RATES

May-July 1971



Note: Data are shown for business days only.

MONEY MARKET RATES QUOTED: Bid rates for three-month Euro-dollars in London; offering rates for directly placed finance company paper; the effective rate on Federal funds (the rate most representative of the transactions executed); closing bid rates (quoted in terms of rate of discount) on newest outstanding three-month Treasury bills.

BOND MARKET YIELDS QUOTED: Yields on new Aa-rated public utility bonds (arrows point from underwriting syndicate reoffering yield on a given issue to market yield on the same issue immediately after it has been released from syndicate restrictions); daily averages of yields on seasoned Aaa-rated corporate bonds; daily averages of yields on long-term Government securities (bonds due or callable in ten years or more) and on Government securities due in three to five years, computed on the basis of closing bid prices; Thursday averages of yields on twenty seasoned twenty-year tax-exempt bonds (carrying Moody's ratings of Aaa, Aa, A, and Baa).

Sources: Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, Moody's Investors Service, and The Weekly Bond Buyer.

ties during July. Market participants were also concerned about the potential size of cash financing needs by both the Treasury and the Federal agencies over the months ahead. Although the long-anticipated increase in the bank prime lending rate to 6 percent and the subsequent rise in the discount rate removed one element of uncertainty, the approach of the Treasury's August refunding became another restraining influence. The anticipation of the announcement of the financing terms on July 21 and the subscription period for the new offerings were dominant influences on market activity during much of July, though participants generally believed that the refunding operation would foster a steady tone in the money market.

In the refunding, the Treasury offered holders of $5.06 billion of 4 percent bonds and 8¼ percent notes maturing August 15 the right to exchange their holdings for a new 7 percent four-year three-month note or a ten-year 7 percent bond. The new notes and bonds were priced to yield about 7.06 percent and 7.11 percent, respectively. In addition, the Treasury accepted cash subscriptions from individuals up to a maximum amount of $10,000 for the new bonds. This offering was the Treasury's first attempt to market a long-term maturity under the recent Congressional authorization permitting the Treasury to sell up to $10 billion in bonds without regard to the 4¼ percent interest rate ceiling on these issues.

Trading in the new issues was sluggish, some sales of the "rights" issues appeared, and prices weakened, reflecting market expectations that a large budget deficit in the current fiscal year would result in subsequent offerings of new issues at still higher rates. Preliminary results of the refunding, announced on July 30, confirmed the generally sluggish market reception of the new issues. Of the $4.12 billion of publicly held issues, $251 million was exchanged for the new ten-year bond and $2.48 billion for the new note, leaving $1.39 billion to be redeemed for cash. Individual investor cash subscriptions for the ten-year bond totaled $192 million. The relatively high 33.6 percent attrition in the exchange operation appeared due in part to the wide dispersal in holdings of maturing issues and to the absence of an "anchor"—or relatively short-term issue—in the refunding package. At the same time that the Treasury announced the preliminary refunding results, it also scheduled an auction of $2.5 billion of eighteen-month 6½ percent notes for August 5, to be issued August 16.

Over the first half of July, yields on Government coupon securities trended moderately lower. The steady tone of the long- and intermediate-term sectors of the market reflected in part strong technical conditions prevailing in this interval. Over the second half of the month, however, yields moved higher and the return on issues maturing in three to five years reached 6.85 percent on July 30, 10 basis points above the end-of-June level, while long-term yields declined to 5.94 percent, down 3 basis points over the month. The climb in intermediate- and long-term yields after midmonth reflected, in part, market adjustment to the refunding and reports of an acceleration in consumer prices in June.

Treasury bill rates fluctuated widely over July but closed the month at levels above those prevailing at the end of June. Contributing to the upward pressure on bill rates in early July was an expanded supply of bills emanating from an increase in the weekly volume of bills auctioned, from tax anticipation bills auctioned on June 30, and from a rise in foreign central bank sales. Therefore, bidding was weak in the first weekly bill auction of the month (advanced to Friday, July 2, because of the Independence Day holiday), resulting in a wide range of prices among the accepted tenders. Average issuing rates for the new three- and six-month issues were set at 5.47 percent and 5.61 percent, respectively (see Table II), 39 and 34 basis points above the rates set in the last auction in June. At these higher rates, stronger interest developed in the July 12 auction, bringing average issuing rates on the three- and six-month maturities down by 9 and 13 basis points, respectively, from the prior week's levels.

The announcement of the hike in the discount rate on July 15, press reports of a sharp jump in the money supply for the week ended July 7, and a marked tightening displayed in published bank reserve statistics resulted in renewed concern over the future course of interest rates, and a cautious tone once again pervaded the market. Bidding in the July 19 auction established average issuing rates for the new three- and six-month bills at 5.55 percent and 5.72 percent, respectively, up 17 and 24 basis points from the levels of the week earlier. Subsequently, overall activity grew quiet and rates eased lower, as participants awaited the Treasury's refunding announcement on July 21. With the approach of the refunding, prospects for the bill sector were brightened by the possibility of some reinvestment demand stemming from the attrition. Furthermore, the absence of a short note issue in the refunding package was a source of some encouragement, and relatively strong interest developed in the bill auction on July 26. Fairly aggressive bidding reflected considerable bank interest, and tenders were accepted within a very narrow range of prices. Average issuing rates for the new three- and six-month bills were set at 5.55 percent and 5.83 percent, respectively, 1 and 11 basis points above the rates set one week earlier. Most bill rates moved lower in the final days of July. Over the month on balance, however, rates on bills of less than three months' maturity rose by 21 to 34 basis points, while most longer bill rates generally rose by 20 to 55 basis points.

Table II

AVERAGE ISSUING RATES*
AT REGULAR TREASURY BILL AUCTIONS

In percent

Maturities	Weekly auction dates—July 1971			
	July 2	July 12	July 19	July 26
Three-month	5.467	5.376	5.546	5.554
Six-month	5.614	5.483	5.724	5.833

Maturities	Monthly auction dates—May-July 1971		
	May 27	June 24	July 27
Nine-month	4.688	5.425	5.944
One-year	4.790	5.567	5.953

* Interest rates on bills are quoted in terms of a 360-day year, with the discounts from par as the return on the face amount of the bills payable at maturity. Bond yield equivalents, related to the amount actually invested, would be slightly higher.

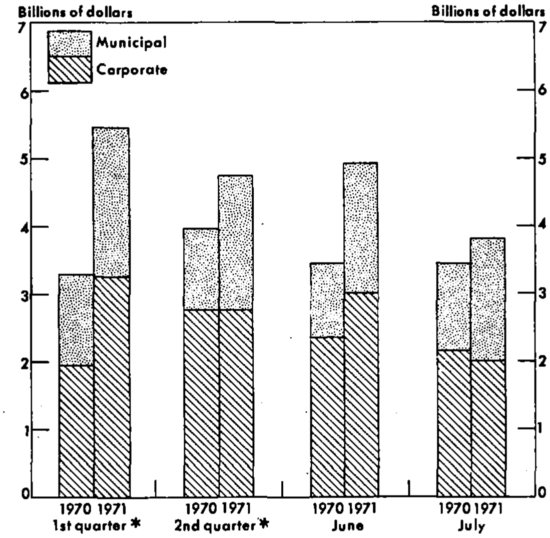
OTHER SECURITIES MARKETS

Activity in the markets for corporate and tax-exempt securities presented a contrasting picture during July. While enthusiastic investor reception of a huge municipal offering early in the month set the stage for subsequent price advances in the tax-exempt sector, the disappointing placement of a key telephone offering typified the fairly indecisive performance in the corporate sector. The market was characterized by the usual summer lull, and the $3.8 billion volume of new corporate and tax-exempt financings fell short of the average monthly flotations in the first and second quarters of this year (see Chart II). The calendar of new issues was nevertheless sizable by comparison with the average monthly volume over the first three quarters of 1970.

After yields on tax-exempt securities had advanced in June to the highest levels of 1971, several new offerings attracted enthusiastic investor demand in early July. On July 7, the largest financing ever undertaken by a city set the pace of activity when New York City sold $357 million of lower medium-grade securities. The city incurred a net annual interest cost of 7.58 percent, the highest in its history. At a record return to investors for a New York City issue, the bonds sold out by the end of the day. Following this event, many other state and local government issues encountered excellent receptions at lower yields. Reflecting the downtrend in yields during the month, *The Weekly Bond Buyer's* twenty-bond yield index recorded a drop in each of the first three weeks of July, and then rose to 6.05 percent on July 29, still 14 basis points below the July 1 level.

After the general increase in the bank prime lending rate, corporate bond prices stabilized and moved higher in moderately active trading. The discount rate advance had been largely discounted earlier, and thus had only a minor effect on the market. A relatively light calendar of new issues buoyed prices, and participants awaited a key telephone company offering scheduled for July 13. The New York Telephone Company sold $150 million Aaa-rated refunding mortgage bonds, with the yield to investors established at 7.90 percent, 10 basis points above the return on a comparable issue marketed three weeks earlier. Though the terms of the financing were almost exactly as predicted by market analysts, market reception was surprisingly lukewarm, as investors resisted attempts to hold yields below 8 percent. This issue was released from price restrictions on July 19, when dealers sought to reduce the backlog of unsold high-grade utility bonds, and the yield jumped to 8.01 percent.

Chart II
CORPORATE AND MUNICIPAL BOND OFFERINGS



* Average monthly volume in the quarter.
Sources: Securities and Exchange Commission; Board of Governors of the Federal Reserve System.

In the wake of the poor investor reception given the New York Telephone bonds, prices of outstanding issues receded. On July 20, a key $100 million Aaa-rated utility issue came to market, bearing a 7.95 percent return to investors, and this offering also encountered a discouraging initial investor response. These bonds were released from price restrictions about a week later, and the yield rose to about 8.13 percent. In contrast, on the following day a major competitively offered utility issue was quickly sold out but at a yield which was 10 basis points above the return on a comparable security marketed a week earlier.

Only two Aa-rated utility offerings came to market in July, attesting to the slow pace of market activity during the month. The first was offered on July 7 and carried an 8 percent yield, which was identical to the return on a comparable issue sold two weeks earlier. The second key utility offering was the most important corporate financing in the last week of July. The new bonds met a poor investor reception, though they were priced to yield 8.20 percent. The jump of 20 basis points above yields on the earlier offerings was an indication of the general rise in corporate bond yields as July drew to a close.